IT 03-0003-PLR 03/04/2003 PUBLIC LAW 86-272/NEXUS

Private Letter Ruling: Drop shipment of goods from Illinois suppliers to customers outside the state will not by itself create nexus for the seller.

March 4, 2003

Dear:

This is in response to your letter dated December 17, 2002, in which you request a Private Letter Ruling on behalf of COMPANY1. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of 86 Ill. Adm. Code Section 1200.110 appears to be contained in your request. The Private Letter Ruling will bind the Department only with respect to COMPANY1 for the issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that COMPANY1 and/or any related taxpayer(s) is not currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them are as follows:

Facts

COMPANY1 is a foreign-owned pharmaceutical company headquartered in New York City and doing business in 11 states. COMPANY1 has its only U.S. warehouse and distribution center in Illinois. COMPANY1 purchases products from its foreign parent or from third parties, packages the products in another state (or contracts with third parties to package products), and then sends the products to its Illinois warehouse, from which it ships to its customers' locations via third party carrier throughout the U.S. For Illinois income tax purposes, COMPANY1 currently does not throw back its sales to customers located in the 11 states in which it has nexus beyond P.L. 86-272 and files returns, but does source or throw back to Illinois its sales to Illinois customers and to customers in the other states in which it does not have nexus.

COMPANY1 recently purchased a controlling interest in COMPANY2, a partnership that runs a pharmaceutical business with its main office in New York city, at which location COMPANY2 accepts all orders from its customers. After the purchase, COMPANY1 directly owns a 4.9% general partnership interest in COMPANY2, and indirectly owns the remaining 95.1% general partnership interest in COMPANY2. After the purchase, COMPANY1 and COMPANY2 sell products manufactured by COMPANY1's parent or by third parties. After COMPANY1's purchase of COMPANY2, however, only COMPANY1 – not COMPANY2 – solicits or sells products for delivery to Illinois destinations.

At the time of purchase, COMPANY2 entered into a contract with COMPANY1, under which COMPANY1's salespersons solicit, market, and sell on behalf of COMPANY2. COMPANY2 fills every customer order by placing an order with COMPANY1. COMPANY1 fills the COMPANY2 order by shipping the product from COMPANY1's Illinois warehouse to COMPANY2 for delivery at the location of COMPANY2's customer. COMPANY1 passes title to COMPANY2 at the COMPANY2 customer location, and COMPANY2 simultaneously passes title to the customer at such location. Unlike the situation in other states, however, COMPANY2 does not solicit or sell products for delivery to Illinois destinations. Moreover, COMPANY1 does not solicit or sell products on COMPANY2's behalf in Illinois nor conduct any other activities on behalf of COMPANY2 in Illinois. Other than the foregoing connections, COMPANY2 has no nexus with Illinois.

For purposes of this request, assume that COMPANY1 and COMPANY2 are members of a unitary business group ("UBG") following COMPANY1's purchase of COMPANY2 and that COMPANY1 will file a combined return in Illinois that includes COMPANY1's distributive share of COMPANY2's business income and apportionment factors.

Rulings requested

We seek rulings that:

1. COMPANY1's sales to COMPANY2 are properly eliminated from the UBG's Illinois sales factor.

2. COMPANY2's sales are properly included in the denominator of the UBG's Illinois sales factor, but not in the numerator.

Analysis and Conclusions

1. COMPANY1's sales to COMPANY2 are sales between members of the UBG and are therefore eliminated for Illinois purposes. See 86 Ill.Adm.Code 100.5270(b)(1).

2. Under regulation 86 Ill.Adm.Code 100.3380(c)(1), a seller's sales are thrown back to Illinois and included in the seller's Illinois sales factor numerator only if the seller has nexus in Illinois that goes beyond the activities protected by Public Law 86-272. While the regulation covers the so-called "double throwback" situation, and does not specifically deal with the throwback of sales whose shipment originates in Illinois, it is difficult to see why the same "nexus" threshold for taxation and throwback would not apply.

We have found no court decisions addressing whether nexus is a precondition to application of the throwback rule. The two authorities we have located, however, suggest that tax nexus is a prerequisite to throwback:

> In Letter Ruling No. 90-200 (8/2/90), an out-of-state direct mail marketer, without property or employees in Illinois, entered into a drop shipment agreement with an Illinois manufacturer to ship the goods directly from the manufacturer's Illinois location to ultimate purchasers located throughout the U.S. Aside from the drop shipment arrangement, the direct marketer had no connection with Illinois. The Department ruled that the drop shipment arrangement would not by itself subject the direct marketer to tax and that the direct marketer's related sales would not be sourced or "thrown back" to Illinois.
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> In Administrative Hearings Decision IT 97-7, the Department addressed a taxpayer's argument that the statute's use of the word "person" in relation to the throwback rule must be read to refer to the entire unitary business group where, as in that case, the taxpayer had elected under Sec. 502(e) to be treated as one taxpayer. The Department found this interpretation inconsistent with the combined method of apportionment. According to the Department's administrative law judge, "Even though taxpayers

> combine their taxable incomes and 'everywhere' factors, the numerator of the apportionment factors must be looked at on an individual company by company basis. *Only corporations which have nexus in Illinois can have Illinois sales included in the numerator."* (Emphasis supplied).

On the facts present in this ruling request, COMPANY2 is not subject to taxation by Illinois, and its sales may not be thrown back to Illinois, since COMPANY2 has no nexus in the state. COMPANY2 has no property, payroll, sales or customers in Illinois, and therefore has no nexus in Illinois as a result of its own activities. COMPANY2 also has no nexus in Illinois as a result of its contract with COMPANY1 for the provision of solicitation services, since COMPANY1 will not perform such services on behalf of COMPANY2 in Illinois. Nor does COMPANY2 acquire nexus as a result of the fact that the goods sold by COMPANY2 to customers in other states will be stored in Illinois prior to the sale, since COMPANY1 (not COMPANY2) leases the Illinois warehouse, owns the inventory and stores the inventory on its own behalf. In other words, COMPANY2 has no business activity in Illinois sufficient to create statutory or constitutional nexus.

Accordingly, COMPANY2's sales are properly included in the denominator, but not in the numerator, of the UBG's Illinois combined return sales factor.

Ruling by Department

With respect to whether COMPANY1's sales to COMPANY2 are properly eliminated from the unitary business group's Illinois sales factor, 86 Ill.Admin.Code 100.5270(b)(1) provides the following guidance:

> Items of income and deduction arising from transactions between members of the unitary business group must be eliminated whenever necessary to avoid distortion of the denominators used by the unitary business group in calculating apportionment factors, or of the numerators used by the combined group or by ineligible members of the group in calculating apportionment factors.

Failure to eliminate from the sales factor a transfer between members of a unitary business group would alter the sales factor of the group. In contrast, a transfer between divisions of a single taxpayer would never affect the sales factor of that taxpayer. Section 502(e) of the Illinois Income Tax Act requires corporate members of a unitary business group to "be treated as one taxpayer." Accordingly, failure to eliminate intercompany sales from the sales factor would cause the amount of business income apportioned to Illinois by a unitary business group to be different from the amount that would be apportioned by a single taxpayer in otherwise identical circumstances. Sales from COMPANY1 to COMPANY2 must therefore be eliminated from the numerator and denominator of the sales factor.

The second issue is whether COMPANY2's sales should be included in the denominator of the unitary business group's Illinois sales factor, but not in the numerator. According to 86 Ill.Admin.Code 100.3380(c)(1):

> In the case of sales where neither the origin nor the destination of the sale is within this State, and the person is taxable in neither the state of origin nor the state of destination, the sale will be attributed to this State (and included in the numerator of the sales factor) if the person's activities in this State in connection with the sales are not protected by the provisions of P.L. 86-272, 15 USC 381-385.

The term "state of origin" refers to the provision in the throwback rule in Section 304(a)(3)(B)(ii) of the Illinois Income Tax Act (35 ILCS 5/101 *et seq.*), which allocates gross proceeds from a sale of tangible personal property to the Illinois sales factor numerator if the seller is not subject to tax in the destination state and "the property is shipped from an office, store, warehouse, factory or other place of storage in this State"; i.e., if Illinois is the state of origin.

This provision can have application only if it is possible for a seller to have no nexus with a state despite the fact that property being sold by the seller is shipped from a place of storage within that state. Accordingly, this provision is based on the assumption that mere shipment of goods from a state on behalf of a person selling those goods will not, of itself, cause that person to have nexus with the state.

There are no Illinois authorities on point, and no authorities in other states that deal with the precise nexus issue under facts similar to those you have represented in the ruling request. However, in *Langley v. Administrative Hearing Commission,* 649 S.W.2d 216 (1983), the Missouri Supreme Court held that a drop shipment was, in fact, two distinct and independent transactions: a purchase of the goods and a resale of the goods by the same party. Based on this reasoning, the court held that sales by a Missouri-based retailer of goods that were drop-shipped from outside Missouri to a Missouri purchaser were transactions occurring entirely within the State of Missouri. For sales factor purposes, the gross receipts from such transactions were therefore allocated entirely to Missouri rather than allocated only fifty percent to Missouri, which would be the proper treatment for a transaction occurring partly within and partly without Missouri. In effect, the court held that the drop shipment from outside Missouri did not establish nexus between the seller and the state of origin with respect to that particular transaction.

Based on that holding, a taxpayer whose only connection with the State of Illinois is through drop shipments of goods from Illinois to purchasers outside the State would not have nexus with the State of Illinois. Note that this letter does not rule that COMPANY2 has no nexus with Illinois, only that no nexus is created by the drop shipment transactions described in your request.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

Very truly yours,

Heidi Scott
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